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T. C. Memo. 1986-79

UNITED STATES TAX COURT

CALVIN HOLDERMAN, JR., Petitioner, v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 11618-80. Filed February 27, 1986.

Held: (1) Respondent's motion to dismiss as to the deficiency for failure properly to prosecute is granted. Rule 123(b), Tax Court Rules of Practice & Procedure.

(2) Addition to tax is imposed under sec. 6653(b) (fraud), I.R.C. 1954. Doncaster v. Commissioner, 77 T.C. 334 (1981).

Calvin Holderman, Jr., pro se.

Robert E. Marum, for the respondent.

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MEMORANDUM OPINION

CHABOT, Judge: Respondent determined a deficiency in Federal individual income tax against petitioner for 1976 in the amount of $16,437.56, and an addition to tax under section 6653(b)[1] (fraud) in the amount of $8,218.78.

The instant case was set for trial at the February 3, 1986, Hartford, Connecticut, trial session. Petitioner failed to appear at the calendar call for this session, and failed to appear 2 days later, when the instant case was recalled.

Respondent moved under Rule 123(b)[2] to dismiss as to the deficiency, and the case was submitted as to the addition to tax under section 6653(b). Respondent's motion to dismiss as to the deficiency is granted; the issue for decision is whether petitioner is liable for the addition to tax under section 6653(b).

When the petition was filed in the instant case, petitioner resided in New Milford, Connecticut.

On November 19, 1985, respondent served on petitioner a request for admissions, with attached exhibits. On November 20, 1985, respondent's request was filed with the Court pursuant to Rule 90. Petitioner failed to respond to this request, and so

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1 Unless indicated otherwise, all section references are to sections of the Internal Revenue Code of 1954 as in effect for the year in issue.

2 Unless indicated otherwise, all rule references are to the Tax Court Rules of Practice & Procedure.

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these requested admissions are deemed admitted and are conclusively established for purposes of the instant case. Freedson v. Commissioner, 65 T.C. 333, 335 (1975), affd. 565 F.2d 954 (CA5 1978); Rule 90(e).

In 1965, petitioner became employed as an airline pilot by The Flying Tiger Line, Inc. (hereinafter sometimes referred to as "Flying Tiger"). He was so employed by Flying Tiger from 1965 to 1985.

Petitioner received a Form W-2 from Flying Tiger showing that in 1976 he received wages in the amount of $56,910.56, from which Federal income tax was withheld in the amount of $6,899.21. A copy of this Form W-2 was attached to the Form 1040 that petitioner filed for 1976. In addition, in 1976 petitioner received $2,158.90 in the form of "expense, per diem, reimbursement" from Flying Tiger. Also, in 1976 petitioner received interest income from several sources, in amounts totalling $15.61.

Petitioner's taxable income for 1976 consists of the items and amounts shown in table 1.

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Table 1

Item		Amount
Wages		$56,910.56
Other income		2,174.51
Gross income		$59,085.07
Less: Itemized deductions	$18,580.66	
Personal exemption	750.00	(19,330.66)
Taxable income		$39,754.41

Petitioner's 1976 Federal income tax liability, based on the taxable income shown in table 1, is $16,437.56--the amount determined by respondent in the notice of deficiency. On the Form 1040 that petitioner filed for 1976, he claimed a refund of $6,899--a rounding down of the amount shown on the 1976 Flying Tiger Form W-2 as withheld income tax--and he did not show an income tax liability.[3] As a result, petitioner has an underpayment of income tax for 1976 in the amount of $16,437.56.

When petitioner filed the Form 1040 for 1976, he knew that he actually had a substantial tax liability for that year. Petitioner's failure to record information that reflected his actual tax liability on the Form 1040 that he filed for 1976 was fraudulent with intent to evade tax. Petitioner fraudulently and

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[3] On the line for tax liability, petitioner showed a double asterisk, which he defined as follows:

> This means specific objection is made under the 5th Amendment, U.S. Constitution, to the question as to Federal Reserve Notes, and that similar objection is made to the question under the 1st, 4th, 7th, 8th, 9th, 10th, 13th, 14th and 16th Amendments.

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with intent to evade tax claimed a refund in the amount of $6,899 on the Form 1040 that he filed for 1976 when he knew he had actually incurred a substantial tax liability for 1976. Petitioner's underpayment of income tax for 1976 is due in whole or in part to fraud with intent on the part of petitioner to evade tax.

We pass over the question of whether the Form 1040 that petitioner filed for 1976 constitutes a tax return (see Reiff v. Commissioner, 77 T.C. 1169, 1176-1180 (1981), and cases cited therein), since that technical question affects neither the issue for decision in the instant case nor the amount of the underpayment as defined in section 6653(c).

As to the addition to tax under section 6653(b),[4] respondent bears the burden of proving by clear and convincing evidence that petitioner has an underpayment, and that some part of this underpayment is due to fraud. Section 7454(a);[5] Rule 142(b);

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SEC. 6653. FAILURE TO PAY TAX.

* * *

(b) Fraud.--If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. * * *

[The subsequent amendment of this provision by section 325(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324, 616, does not affect the instant case.]

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SEC. 7454. BURDEN OF PROOF IN FRAUD, FOUNDATION MANAGER, AND TRANSFEREE CASES.

(a) Fraud.--In any proceeding involving the issue whether

(footnote continued)

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e.g., Stone v. Commissioner, 56 T.C. 213, 220 (1971); Otsuki v. Commissioner, 53 T.C. 96, 105 (1969).

Fraud is an actual intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing. E.g., Webb v. Commissioner, 394 F.2d 366, 377 (CA5 1968), affg. a Memorandum Opinion of this Court;[6] Powell v. Granquist, 252 F.2d 56, 60 (CA9 1958); Estate of Pittard v. Commissioner, 69 T.C. 391, 400 (1977); McGee v. Commissioner, 61 T.C. 249, 256-257 (1973), affd. 519 F.2d 1121 (CA5 1975). This intent may be inferred from circumstantial evidence (Powell v. Granquist, 252 F.2d at 61; Gajewski v. Commissioner, 67 T.C. 181, 200 (1976), affd. without published opinion 578 F.2d 1383 (CA8 1978)), and by deemed admissions (Doncaster v. Commissioner, 77 T.C. 334, 337 (1981); see Freedson v. Commissioner, supra.) Respondent need not prove the precise amount of underpayment resulting from fraud, but only that there is some underpayment and that some part of it is attributable to fraud. E.g., Kreps v. Commissioner, 351 F.2d 1, 6 (CA2 1965), affg. 42 T.C. 660 (1964).

(footnote continued from previous page)
the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary of his delegate.

[The subsequent amendment of this provision by section 1906(b)(13)[sic](A) of the Tax Return Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1834, does not affect the instant case.]

6 T.C. Memo. 1966-81.

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As to the existence of an underpayment, we conclude (and we have found) that respondent has proven this fact, based on the facts deemed admitted under Rule 90(e). As to the existence of fraud as to some part of this underpayment, we conclude (and we have found), following Doncaster v. Commissioner, supra, that the facts deemed admitted under Rule 90(e) establish the existence of such fraud in the year in issue.

We hold for respondent.

An appropriate order granting respondent's motion under Rule 123(b) will be issued, and decision will be entered for respondent.

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T. C. Memo. 1986-80

UNITED STATES TAX COURT

PAUL R. STOUT, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19351-82. Filed March 3, 1986.

Held: (1) Deficiencies in income tax for each year 1973 through 1980 sustained.

(2) Additions to tax under secs. 6653(b) and 6654, I.R.C. 1954, sustained.

(3) Fraud tolled the running of the statute of limitations under sec. 6501(c)(1), I.R.C. 1954.

Paul R. Stout, pro se.

Robert F. Simon, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

SIMPSON, Judge: The Commissioner determined the following deficiencies in, and additions to, the petitioner's Federal income taxes:

		Additions to Tax	
Year	Deficiency	Sec. 6653(b) I.R.C. 1954[1]	Sec. 6654 I.R.C. 1954
1973	$ 6,323.25	$3,161.63	$133.93
1974	3,631.64	1,815.82	58.55
1975	4,231.40	2,115.70	181.76
1976	7,575.86	3,787.93	240.24
1977	8,348.25	4,174.12	297.05
1978	19,292.91	9,646.45	- 0 -
1979	12,350.49	6,175.25	454.31
1980	1,359.00	679.50	26.58

The issues for decision are: (1) Whether the Commissioner correctly determined the petitioner's income tax deficiencies for each of the years 1973 through 1980; (2) whether the petitioner is liable for additions to tax for fraud under the provisions of section 6653(b) for each of the years 1973 through 1980; (3) whether the petitioner is liable for additions to tax for underpayment of estimated tax pursuant to section 6654 for the years 1973 through 1977, 1979, and 1980; and (4) whether, under the provisions of section 6501, the assessment and collection of the income

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1 All statutory references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

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tax deficiencies for the years 1973 through 1978 is barred by the statute of limitations.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

The petitioner, Paul R. Stout, maintained his legal residence in Lombard, Ill., on the date the petition in this case was filed. During the years 1973 through 1980, the petitioner was married to Florence Stout.

In 1939, the petitioner received a bachelor's degree from Miami University (Ohio), with the dual academic honors of Phi Beta Kappa and Cum Laude. He was enrolled as a graduate fellow at Northwestern University in the field of organic chemistry from 1939 through 1942. The petitioner has also taken several courses at the University of Chicago. He was employed by the Quaker Oats Company (Quaker) from 1944 until his retirement in May 1978. From 1978 through 1979, he was employed by Systems Development Corporation (Systems Development). In 1979, by virtue of a corporate divestiture, the petitioner started employment with Applied Information Development, Inc. (Applied Information), and he continued to work there in 1980.

The petitioner filed his 1967 and 1968 joint income tax returns in 1969. On each return, he reported receipt of wages from Quaker, interest income, and itemized deductions,

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including deductions for claimed charitable contributions. On April 15, 1971, he filed joint returns for 1969 and 1970. He received an income tax refund for each of the years 1967 through 1970.

The petitioner did not timely file income tax returns for 1971 or 1972. In 1974, he was interviewed by an IRS special agent concerning his failure to file income tax returns for those years. The petitioner admitted that he had not filed the returns and agreed to file them. Shortly after the interview, he filed his 1971 and 1972 returns. On these returns, he claimed charitable deductions for contributions to the Larchmont Foundation totaling over $5,000. At the same time, the petitioner, as president of the foundation, reported that the foundation had received no income or contributions during 1971 and 1972.

The petitioner created an alleged church, the Chapel of the Tolerants, in 1972. The church's basic beliefs and structure were developed by him. In addition, he made himself head of the church. In 1976, the petitioner changed its name to the Adena Free Church, Inc. (Adena). He, pursuant to a voluntary vow of poverty, transferred certain of his assets to Adena and occasionally deposited his paycheck in the Adena bank account. The petitioner, at his sole discretion, used funds from the bank account and assets transferred to Adena for the benefit of himself and his

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family. All of the assets transferred were to revert to him if Adena was not recognized for tax purposes.

In 1966, the petitioner submitted a Form W-4, Employee's Withholding Allowance Certificate, which properly listed five exemptions. In 1972, he submitted a Form W-4 on which he claimed 16 exemptions. In 1974, he submitted a Form W-4 on which he falsely claimed 34 exemptions. As a result, no amounts for Federal income tax were withheld from his wages for the years 1975, 1976, and 1977.

For 1973, 1974, 1975, and 1976, the petitioner filed no United States income tax returns, or alleged returns, until 1977. In February 1977, he filed tax protestor documents for such years; that is, for each year he filed a Form 1040 containing the name of himself and his wife, but containing no other information. In connection with each form, he attached materials stating:

> 1. This return is filed under protest.
>
> * * *
>
> 3. This return is a petition for redress of grievances.
>
> * * *
>
> 7. We offer to amend or re-file this return so as to be exactly as you wish it, if you will first show us how to do so without waiving our Constitutional rights.
>
> 8. We are confused as to the meaning of "dollars", "silver, gold, Constitutional, statutory, fiat, and paper dollars", and the "relative", "actual", "par", or "parity" value thereof. We are also confused as to the meaning of "legal tender", "lawful money", "gross income", "notes receivable", Federal Reserve Notes -- "receivables" and "non-receivables" -- that is to say, "non-redeemable". We

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are also confused as to the reportability of "bad debts" and we understand that "accounts receivables" are not reportable as "gross income" for a cash basis taxpayer.

9. Asterisks (**) appearing on Pages 1 and 2 of this return signify the following; ** Specific objection is made to this question under the Fifth Amendment, U.S. Constitution, as to Federal Reserve Notes and rights under said Amendment; and similar objection is made to the question under the First, Fourth, Seventh, Eighth, Ninth, Tenth, Thirteenth, Fourteenth, and Sixteenth Amendments.

10. The signatures appearing below are involuntarily given under threat of statutory punishment.

In June 1977, the petitioner filed a document which claimed to be an amended return for the years 1969 through 1976 and on which he claimed a refund for all taxes paid during those years. To the alleged amended return, the petitioner attached materials containing the standard objections of the tax protest movement to the income tax system.

During 1978, the petitioner filed tax protestor type documents for 1977. Such documents included a Form 1040, on which the petitioner identified himself as "Reverend Paul R. Stout" and claimed 11 exemptions; he reported no income and claimed a refund of taxes withheld; he signed the form and attached a vow of poverty in favor of Adena. On June 29, 1978, the petitioner was adjudged guilty by Jury verdict for violations of section 7203 for willful failure to file income tax returns for 1973, 1974, and 1975 and for violation of section 7205 for willful filing of a false Form W-4 for the year 1974. In September 1978, the petitioner

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submitted a Form W-4 to Systems Development in which he falsely claimed 16 exemptions.

On May 17, 1979, the petitioner filed a return for 1978, on which he again identified himself as "Reverend Paul R. Stout." On such return, he reported his wages from Quaker and Systems Development amounting to $46,913.19, and claimed a deduction of $46,731.94 for alleged contributions to Adena. As a result, the return indicated he had no tax liability, and he claimed a refund for the taxes withheld.

In 1979, the petitioner began receiving monthly pension payments from the Quaker employee pension plan, and he continued to receive such payments in 1980. In 1979, the petitioner submitted a Form W-4 to Applied Systems in which he claimed to be exempt from taxation. The petitioner never filed a return for 1979. He and his wife did file a timely joint return for 1980, on which they reported the petitioner's wages from Applied Information but not his pension payments from Quaker.

For all of the years at issue, the appropriate Forms W-2, summarizing compensation received and income tax withheld during the year, and Forms W-2P, summarizing pension benefits received and income tax withheld during the year, were sent to the petitioner. Such forms show that the petitioner received the following amounts of wages or pension:

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Year	Total
1973	$30,342.88
1974	23,841.79
1975	25,741.27
1976	26,951.72
1977	27,876.50
1978	46,913.19
1979	38,295.92
1980	15,683.43

In his notice of deficiency, issued to the petitioner on April 30, 1982, the Commissioner determined that the petitioner was liable for a deficiency for each of the years at issue, that he was liable for the addition to tax under section 6653(b) for fraud for each of such years, and that he was liable for the addition to tax under section 6654 for each of such years except for 1978. In the notice of deficiency, the Commissioner included as unreported income for 1979 only $10,108.96; subsequently, he amended his answer twice and claimed that the unreported income for such year was $36,650.91 and claimed an increased deficiency accordingly.

OPINION

The first issue for decision is whether the Commissioner correctly determined the petitioner's income tax deficiencies for the years 1973 through 1980. The petitioner bears the burden of proof with regard to deficiencies set forth in the notice of deficiency. Rule

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142(a), Tax Court Rules of Practice and Procedure[2]; Welch v. Helvering, 290 U.S. 111 (1933). The Commissioner has the burden of proof concerning deficiencies raised subsequent to the notice of deficiency. Rule 142(a); see, e.g., Jasionowski v. Commissioner, 66 T.C. 312, 318 (1976). Therefore, the petitioner has the burden of proof with regard to all deficiencies except for the increase in the deficiency for 1979 claimed by the Commissioner in his second amendment to answer.

The petitioner has failed to meet his burden. At trial, he introduced no evidence to disprove the Commissioner's determinations. The petitioner was content to present this Court with a series of tax protest contentions which are so patently frivolous that their refutation merits no discussion. See Rowlee v. Commissioner, 80 T.C. 1111 (1983).

The Commissioner met his burden of proof with regard to the increase in the deficiency in 1979. He proved that the petitioner had received wages of $26,541.95 which had not been reported and which were not included in the notice of deficiency. Therefore, the Commissioner's deficiency determinations are sustained.

The second issue for decision is whether the petitioner is liable for the addition to tax for fraud for each of the

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2 Any reference to a Rule is to the Tax Court Rules of Practice and Procedure.

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years 1973 through 1980. Section 6653(b) provides that if any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. The Commissioner bears the burden of proving fraud by clear and convincing evidence. Sec. 7454(a); Rule 142(b); Levinson v. United States, 496 F.2d 651, 654-655 (3d Cir. 1974); Miller v. Commissioner, 51 T.C. 915, 918 (1969). The Commissioner has clearly established that the petitioner underpaid his taxes in 1973 through 1980; we must determine whether the underpayments were due to fraud.

The Commissioner will carry his burden if he shows that the taxpayer intended to evade taxes which he knew or believed that he owed by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968); Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968), affg. a Memorandum Opinion of this Court; Acker v. Commissioner, 26 T.C. 107, 111-112 (1956). The presence of fraud is a factual question to be determined by an examination of the entire record. Mensik v. Commissioner, 328 F.2d 147, 150 (7th Cir. 1964), affg. 37 T.C. 703 (1962); Otsuki v. Commissioner, 53 T.C. 96, 105 (1969). Evidence of prior and subsequent similar acts reasonably close to the years at issue may be considered. United States v. Johnson, 386 F.2d 630, 631 (3d Cir. 1967).

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The Commissioner has adduced considerable evidence to show the petitioner's fraud. The petitioner is an intelligent and educated man, who, in years prior to those in question, properly completed returns. In addition, the personal interview he had with an IRS special agent in 1974, concerning failure to file returns, could only have increased the petitioner's awareness of the importance of filing a return each year.

The petitioner was convicted in 1978 of violating section 7203 for his willful failure to file returns for each of the years 1973, 1974, and 1975, and thus, he is estopped from denying that he willfully failed to file returns for those years. Tomlinson v. Lefkowitz, 334 F.2d 262, 266 (5th Cir. 1964); Castillo v. Commissioner, 84 T.C. 405 (1985). The tax protestor documents filed by the petitioner for the years 1976 and 1977 and the document he filed purporting to amend his "returns" for 1969 through 1976 contained no information from which his tax liability could be determined and therefore did not constitute returns within the meaning of section 6011 and the regulations thereunder. United States v. Porth, 426 F.2d 519 (10th Cir. 1970); Jarvis v. Commissioner, 78 T.C. 646 (1982). For 1979, the petitioner did not file a return or any document claiming to be a return. Although his failure to file tax returns is not conclusive proof of fraudulent intent, it may be considered with other facts in determining whether any

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part of the underpayment of tax is due to fraud. Marsellus v. Commissioner, 544 F.2d 883, 885 (5th Cir. 1977), affg. a Memorandum Opinion of this Court; Stoltzfus v. United States, 398 F.2d at 1005; Rowlee v. Commissioner, 80 T.C. at 1123-1124; Beaver v. Commissioner, 55 T.C. 85, 93 (1970).

The petitioner did file a valid, though delinquent, return for 1978. However, on it, he claimed a deduction for a contribution to Adena in virtually the same amount as the income reported thereon. This deduction was clearly non-allowable because the earnings of the church inured to the benefit of the petitioner and his family. Sec. 170(c). Given the control that the petitioner retained over the assets transferred to Adena, the benefit he received from Adena expenditures, and the other circumstances of this case, we find that the Adena Free Church was a sham created for the sole purpose of tax avoidance. Stephenson v. Commissioner, 79 T.C. 995 (1982), affd. per curiam 748 F.2d 331 (6th Cir. 1984); McGahen v. Commissioner, 76 T.C. 468 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983). Moreover, a person as intelligent and well educated as the petitioner knew, or should have known, that he was not entitled to a charitable deduction equal to his income. Sec. 170(b).

For 1980, the petitioner and his wife filed a timely tax return, but on it, they failed to report the pension that the petitioner received from Quaker. The omission was substantial, and we are convinced that the omission was

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deliberate; the petitioner knew that pension payments are taxable income, and he received a Form W-2P reminding him of the amounts of such payments.

Other evidence of fraud is the series of false statements made by the petitioner to avoid the withholding of taxes. In 1966, he filed a correct Form W-4. However, in 1974 and 1978, he filed false Forms W-4 for the clear purpose of avoiding withholding taxes. In 1978, he was convicted under section 7205 for having filed such false statements; nevertheless, he filed another false statement 3 months later. In 1979, a year after his conviction, he filed still another false Form W-4. This series of false statements indicates beyond a doubt that the petitioner was pursuing conduct designed to evade his tax liabilities. See Hebrank v. Commissioner, 81 T.C. 640, 642 (1983); Rowlee v. Commissioner, 80 T.C. at 1125-1126; Habersham-Bey v. Commissioner, 78 T.C. 304, 313 (1982).

The petitioner claimed large deductions for charitable contributions allegedly made to the Larchmont Foundation in 1971 and 1972. Yet, the petitioner, as its president, stated that the foundation did not receive any income or contributions during such years. Clearly, one of the petitioner's statements was false.

We are convinced that this evidence taken as a whole indicates that the petitioner knew of his obligation to file returns and pay taxes and that he attempted to evade his

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responsibilities during each of the years at issue. The petitioner's fraud is not vitiated because it may have been motivated by a political belief that the law is wrong or by an unreasonable belief that particular tax statutes are unconstitutional. Freedom of expression does not include the right to defraud the Government. See United States v. Moore, 627 F.2d 830 (7th Cir. 1980); United States v. Malinowski, 472 F.2d 850 (3d Cir. 1973); Rowlee v. Commissioner, 80 T.C. at 1125; Habersham-Bey v. Commissioner, 78 T.C. at 313-314. We have here a long record of an intelligent and resourceful taxpayer who has used virtually every conceivable device to evade the payment of taxes, and without any doubt or reservation, we sustain the Commissioner's determination of fraud for each of the years at issue.

The third issue for decision is whether the petitioner is liable for additions to tax, pursuant to section 6654, for underpayment of estimated tax for the years 1973 through 1977, 1979, and 1980. The imposition of this addition to tax is mandatory, unless the petitioner can bring himself within one of the exceptions of this section. Mitchell v. Commissioner, 51 T.C. 641, 648 (1969), revd. 430 F.2d 1 (5th Cir. 1970), revd. 403 U.S. 190 (1971); Estate of Reuben v. Commissioner, 33 T.C. 1071, 1072 (1960). Since the petitioner has made no effort to introduce evidence to disprove the Commissioner's determination, we sustain the

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additions to tax. Sec. 6654(a); Reaver v. Commissioner, 42 T.C. 72, 83 (1964).

The final issue for decision is whether the assessment and collection of the income tax deficiencies for the years 1973 through 1978 is barred by the statute of limitations.[3] Since the Commissioner has sustained his burden of proving fraud for each such year, the statute of limitations remains open under section 6501(c)(1). Estate of Temple v. Commissioner, 67 T.C. 143, 159-160 (1976); Harper v. Commissioner, 54 T.C. 1121, 1142 (1970).

Decision will be entered for the respondent.

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3 The Commissioner describes the issue as relating to 1973 through 1979. However, the notice of deficiency was issued on April 30, 1982, which is within 3 years of the due date for the 1979 return.

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Ja11.7/2:1986-81

COMPLETED

T. C. Memo. 1986-81

UNITED STATES TAX COURT

SAM GILLIAM, JR. and DOROTHY B. GILLIAM, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 4986-79. Filed March 3, 1986.

Petitioner-husband was travelling by airplane on a business trip, when suddenly he began to act in a bizarre and irrational manner; he also threatened two members of the flight crew and assaulted a passenger. After the airplane landed, petitioner-husband was arrested. Two weeks later, he was indicted. At trial, the court rendered an acquittal verdict by reason of temporary insanity. Petitioners paid $16,850 for legal fees in the criminal case and paid $3,800 to the assaulted passenger in settlement of a related civil claim .

Held: The expenses are not "ordinary"; the amounts paid are not deductible under sec. 162, I.R.C. 1954. Dancer v. Commissioner, 73 T.C. 1103 (1980), and Clark v. Commissioner, 30 T.C. 1330 (1958), are distinguishable.

David Povich, for the petitioners.

Lewis R. Carluzzo, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

CHABOT, Judge: Respondent determined deficiencies in Federal individual income taxes against petitioners for 1975 and 1976 in the amounts of $4,529 and $3,159, respectively.[1] After concessions by petitioners, the issue for decision[2] is whether petitioners are entitled to deduct under section 162 the amounts paid in defense of a criminal prosecution and in settlement of a related civil claim.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulation and the stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, petitioners Sam Gilliam, Jr. (hereinafter sometimes referred to as "Gilliam"), and Dorothy B. Gilliam, husband and wife, resided in Washington, D.C.

Gilliam was born in Tupelo, Mississippi, in 1933, and raised in Louisville, Kentucky. In 1961, he received a master of arts degree in painting from the University of Louisville.

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1 Of these amounts, self-employment taxes under chapter 2 are $200 for 1975 and $611 for 1976; the remaining amounts are chapter 1 income tax.

Unless indicated otherwise, all section and chapter references are to sections and chapters of the Internal Revenue Code of 1954 as in effect for the years in issue.

2 The self-employment tax adjustments and medical expense adjustments are derivative and depend on the resolution of the issue for decision.

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Gilliam is, and was at all material periods, a noted artist. His works have been exhibited in numerous art galleries throughout the United States and Europe, including the Corcoran Gallery of Art, Washington, D.C.; the Philadelphia Museum of Art, Philadelphia, Pennsylvania; the Karl Solway Gallery, Cincinnati, Ohio; the Phoenix Gallery, San Francisco, California; and the University of California, Irvine, California. His works have also been exhibited and sold at the Fendrick Gallery, Washington, D.C. In addition, Gilliam is, and was at all material periods, a teacher of art. On occasion, Gilliam lectured and taught art at various institutions.

Gilliam accepted an invitation to lecture and teach for a week at the Memphis Academy of Arts in Memphis, Tennessee. On Sunday, February 23, 1975, he flew to Memphis to fulfill this business obligation.

Gilliam had a history of hospitalizations for mental and emotional disturbances and continued to be under psychiatric care until the time of his trip to Memphis. In December 1963, Gilliam was hospitalized in Louisville; Gilliam had anxieties about his work as an artist. For periods of time in both 1965 and 1966, Gilliam suffered from depression and was unable to work. In 1970, Gilliam was again hospitalized. In 1973, while Gilliam was a visiting artist at a number of university campuses in

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California, he found it necessary to consult an airport physician; however, when he returned to Washington, D.C., Gilliam did not require hospitalization.

Before his Memphis trip, Gilliam created a 225-foot painting for the Thirty-fourth Biennial Exhibition of American Painting at the Corcoran Gallery of Art (hereinafter sometimes referred to as "the Exhibition"). The Exhibition opened on Friday evening, February 21, 1975. In addition, Gilliam was in the process of preparing a giant mural for an outside wall of the Philadelphia Museum of Art for the 1975 Spring Festival in Philadelphia. The budget plans for this mural were due on Monday, February 24, 1975.

On the night before his Memphis trip, Gilliam felt anxious and unable to rest. On Sunday morning, Gilliam contacted Ranville Clark (hereinafter sometimes referred to as "Clark"), a doctor Gilliam had been consulting intermittently over the years, and asked Clark to prescribe some medication to relieve his anxiety. Clark arranged for Gilliam to pick up a prescription of the drug Dalmane on the way to the airport. Gilliam had taken medication frequently during the preceding 10 years. Clark had never before prescribed Dalmane for Gilliam.

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On Sunday, February 23, 1975, Gilliam got the prescription and at about 3:25 p.m., he boarded American Airlines flight 395 at Washington National Airport, Washington, D.C., bound for Memphis. Gilliam occupied a window seat. He took the Dalmane for the first time shortly after boarding the airplane.

About one and one-half hours after the airplane departed Washington National Airport, Gilliam began to act in an irrational manner. He talked of bizarre events and had difficulty in speaking. According to some witnesses, he appeared to be airsick and held his head. Gilliam began to feel trapped, anxious, disoriented, and very agitated. Gilliam said that the plane was going to crash and that he wanted a life raft. Gilliam entered the aisle and, while going from one end of the airplane to the other, he tried to exit from three different doors. Then Gilliam struck Seiji Nakamura (hereinafter sometimes referred to as "Nakamura"), another passenger, several times with a telephone receiver. Nakamura was seated toward the rear of the airplane, near one of the exits. Gilliam also threatened the navigator and a stewardess, called for help, and cried. As a result of the attack, Nakamura sustained a one-inch laceration above his left eyebrow which required four sutures. Nakamura also suffered ecchymosis of the left arm and pains in his left wrist. Nakamura was treated for these injuries at Methodist Hospital in Memphis.

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On arriving in Memphis, Gilliam was arrested by Federal officials. On March 10, 1975, Gilliam was indicted. He was brought to trial in the United States District Court for the Western District of Tennessee, Western Division, on one count of violation of 49 U.S.C. § 1472(k) (relating to certain crimes aboard an aircraft in flight) and two counts of violation 49 U.S.C. § 1472(j) (relating to interference with flight crew members or flight attendants). Gilliam entered a plea of not guilty to the criminal charges. The trial began on September 8, 1975, and ended on September 10, 1975. After Gilliam presented all of his evidence, the district court granted Gilliam's motion for a judgment of acquittal by reason of temporary insanity.

Petitioners paid $8,250 and $8,600 for legal fees in 1975 and 1976, respectively, in connection with both the criminal trial and Nakamura's civil claim. In 1975, petitioners also paid $3,800 to Nakamura in settlement of the civil claim.

Petitioners claimed deductions for the amounts paid in 1975 and 1976 on the appropriate individual income tax returns. Respondent disallowed the amounts claimed in both years attributable to the incident on the airplane.[3]

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[3] Although in both years respondent disallowed petitioners' expenditures arising out of the incident on the airplane and allowed the remainder of the claimed legal and professional fees deduction, the record fails to indicate why for 1976 respondent disallowed an additional $1,000 over the amount petitioners paid for Gilliam's legal representation. Since petitioners dispute only the disallowed deductions which relate to the incident on the airplane and both sides agree that petitioners paid $8,600 for legal fees in 1976, we deem petitioners to have conceded the (footnote continued)

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* * * * * * *

Gilliam's trip to Memphis was a trip in furtherance of his trades or businesses.

Petitioners' expenses for the legal fees and claim settlement described, supra, are not ordinary expenses of Gilliam's trades or businesses.

OPINION

Petitioners contend that they are entitled to deduct the amounts paid in defense of the criminal prosecution and in settlement of the related civil claim under section 162.[4] Petitioners maintain that the instant case is directly controlled by our decision in Dancer v. Commissioner, 73 T.C. 1103 (1980). According to petitioners, "[t]he clear holding of Dancer is * * * that expenses for litigation arising out of an accident which occurs during a business trip are deductible as ordinary and

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(footnote continued from previous page)
additional $1,000 claimed as a legal and professional fees deduction for 1976. Jarvis v. Commissioner, 78 T.C. 646, 658 n. 19 (1982); Rule 34(b)(4), Tax Court Rules of Practice & Procedure.

[4] At trial, petitioners asserted that the amounts paid were deductible under section 162 and section 212. On brief, petitioners do not address the deductibility of the amounts paid under section 212. Whether this constitutes a concession by petitioners is unclear; however, it does not affect the analysis herein, since the same criteria apply to the deduction of expenses under section 162 and section 212. Rodney v. Commissioner, 53 T.C. 287, 320 (1969).

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necessary business expenses." Petitioners also contend that Clark v. Commissioner, 30 T.C. 1330 (1958), is to the same effect as Dancer.

Respondent maintains that Dancer and Clark are distinguishable. Respondent contends that the legal fees paid are not deductible under either section 162 or section 212 because the criminal charges against Gilliam were neither directly connected with nor proximately resulted from his trade or business and the legal fees were not paid for the production of income. Respondent maintains that "the criminal charges which arose as a result of * * * [the incident on the airplane], could hardly be deemed 'ordinary,' given the nature of [Gilliam's] profession." Respondent contends "that the provisions of section 262 control this situation." As to the settlement of the related civil claim, respondent asserts that since Gilliam committed an intentional tort, the settlement of the civil claim constitutes a nondeductible personal expense.

We agree with respondent that the expenses are not ordinary expenses of Gilliam's trade or business.

Section 162(a)[5] allows a deduction for all the ordinary and necessary expenses of carrying on a trade or business. In order for the expense to be deductible by a taxpayer, it must be an

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[5] Section 162(a) provides in relevant part as follows:

SEC. 162. TRADE OR BUSINESS EXPENSES.
(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

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ordinary expense, it must be a necessary expense, and it must be an expense of carrying on the taxpayer's trade or business. If any one of these requirements is not met, the expense is not deductible under section 162(a). Deputy v. du Pont, 308 U.S. 488 (1940); Welch v. Helvering, 290 U.S. 111 (1933); Kornhauser v. United States, 276 U.S. 145 (1928). In Deputy v. du Pont, the Supreme Court set forth a guide for application of the statutory requirement that the expense be "ordinary", as follows (308 U.S. at 494-497):

> In the second place, these payments were not "ordinary" ones for the conduct of the kind of business in which, we assume arguendo, respondent was engaged. The District Court held that they were "beyond the norm of general and accepted business practice" and were in fact "so extraordinary as to occur in the lives of ordinary business men not at all" and in the life of the respondent "but once."[8] Certainly there are no norms of conduct to which we have been referred or of which we are cognizant which would bring these payments within the meaning of ordinary expenses for conserving and enhancing an estate. We do not doubt the correctness of the District Court's finding that respondent embarked on this program to the end that his beneficial stock ownership in the du Pont Company might be conserved and enhanced. But that does not make the cost to him an "ordinary" expense within the meaning of the Act. Ordinary has the connotation of normal, usual, or customary. To be sure, an expense may be ordinary though it happen but once in the taxpayer's lifetime. Cf. Kornhauser v. United States, supra. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved. Welch v. Helvering, supra, 114. Hence, the fact that a particular expense would be an ordinary or common one in the course of one business and so deductible under § 23(a) does not necessarily make it such in connection with another business. * * * As stated in Welch v. Helvering, supra, pp. 113-114: ". . . What is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance."

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[8] 22 F.Supp. 589, 597.

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> One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. The fact that an obligation to pay has arisen is not sufficient. It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.
>
> Review of the many decided cases is of little aid since each turns on its special facts. But the principle is clear. And on application of that principle to these facts, it seems evident that the payments in question cannot be placed in the category of those items of expense which a conservator of an estate, a custodian of a portfolio, a supervisor of a group of investments, a manager of wide financial and business interests, or a substantial stockholder in a corporation engaged in conserving and enhancing his estate would ordinarily incur. We cannot assume that they are embraced within the normal overhead or operating costs of such activities. There is no evidence that stockholders or investors, in furtherance of enhancing and conserving their estates, ordinarily or frequently lend such assistance to employee stock purchase plans of their corporations. An in absence of such evidence there is no basis for an assumption, in experience or common knowledge, that these payments are to be placed in the same category as typically ordinary expenses of such activities, e.g., rental of safe deposit boxes, cost of investment counsel or of investment services, salaries of secretaries and the like. Rather these payments seem to us to represent most extraordinary expenses for that type of activity. Therefore, the claim for deduction falls, as did the claim of an officer of a corporation who paid its debts to strengthen his own standing and credit. Welch v. Helvering, supra. And the fact that the payments might have been necessary in the sense that consummation of the transaction with the Delaware Company was beneficial to respondent's estate is of no aid. For Congress has not decreed that all necessary expenses may be deducted. Though plainly necessary they cannot be allowed unless they are also ordinary. Welch v. Helvering, supra.

Petitioners bear the burden of proving entitlement to a deduction under section 162. Welch v. Helvering, 290 U.S. at 115; Rule 142(a), Tax Court Rules of Practice & Procedure. Gilliam is a noted artist and teacher of art. It undoubtedly is

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ordinary for people in Gilliam's trades or businesses to travel (and to travel by air) in the course of such trades or businesses; however, we do not believe it is ordinary for people in such trades or businesses to be involved in altercations of the sort here involved in the course of any such travel. The travel was not itself the conduct of Gilliam's trades or businesses. Also, the expenses here involved are not strictly a cost of Gilliam's transportation. Finally, it is obvious that neither the altercation nor the expenses were undertaken to further Gilliam's trades or businesses.

We conclude that Gilliam's expenses are not ordinary expenses of his trades or businesses.

It is instructive to compare the instant case with Dancer v. Commissioner, supra, upon which petitioners rely. In both cases, the taxpayer was travelling on business. In both cases, the expenses in dispute were not the cost of the travelling, but rather were the cost of an untoward incident that occurred in the course of the trip. In both cases, the incident did not facilitate the trip or otherwise assist the taxpayer's trade or business. In both cases, the taxpayer was responsible for the incident; in neither case was the taxpayer willful. In Dancer, the taxpayer was driving an automobile; he caused an accident which resulted in injuries to a child. The relevant expenses were the taxpayer's payments to settle the civil claims arising from the accident. 73 T.C. at 1105. In the instant case,

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Gilliam was a passenger in an airplane; he apparently committed acts which would have been criminal but for his temporary insanity, and he injured a fellow passenger. Gilliam's expenses were the costs of his successful legal defense, and his payments to settle Nakamura's civil claim.

In Dancer, we stated as follows (73 T.C. at 1108-1109):

> It is true that the expenditure in the instant case did not further petitioner's business in any economic sense; nor is it, we hope, the type of expenditure that many businesses are called upon to pay. Nevertheless, neither factor lessens the direct relationship between the expenditure and the business. Automobile travel by petitioner was an integral part of this business. As rising insurance rates suggest, the cost of fuel and routine servicing are not the only costs one can expect in operating a car. As unfortunate as it may be, lapses by drivers seem to be an inseparable incident of driving a car. Anderson v. Commissioner [81 F.2d 457 (CA10 1936)]. Costs incurred as a result of such an incident are just as much a part of overall business expenses as the cost of fuel. [Emphasis supplied.]

Dancer is distinguishable.

In Clark v. Commissioner, supra, also relied on by petitioners, the expenses consisted of payments of (a) legal fees in defense of a criminal prosecution and (b) amounts to settle a related civil claim. In this regard, the instant case is similar to Clark. In Clark, however, the taxpayer's activities that gave rise to the prosecution and civil claim were activities directly in the conduct of Clark's trade or business. In the instant case, Gilliam's activities were not directly in the conduct of his trades or businesses. Rather, the activities merely occurred in the course of transportation connected with Gilliam's trades

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or businesses. And, as we noted in Dancer v. Commissioner, 73 T.C. at 1106, "in cases like this, where the cost is an adjunct of and not a direct cost of transporting an individual, we have not felt obliged to routinely allow the expenditure as a transportation cost deduction."

Petitioners also rely on Commissioner v. Tellier, 383 U.S. 687 (1966), in which the taxpayer was allowed to deduct the cost of an unsuccessful criminal defense to securities fraud charges. The activities that gave rise to the criminal prosecution in Tellier were activities directly in the conduct of Tellier's trade or business. Our analysis of the effect of Clark v. Commissioner, applies equally to the effect of Commissioner v. Tellier.

In sum, Gilliam's expenses were of a kind similar to those of the taxpayers in Tellier and Clark; however the activities giving rise to Gilliam's expenses were not activities directly in the conduct of his trades or businesses, while Tellier's and Clark's activities were directly in the conduct of their respective trades or businesses. Gilliam's expenses were related to his trades or businesses in a manner similar to those of the taxpayer in Dancer; however Gilliam's actions giving rise to the expenses were not shown to be ordinary, while Dancer's were shown to be ordinary. Tellier, Clark, and Dancer all have similarities

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to the instant case; however, Tellier, Clark, and Dancer are distinguishable in important respects. The expenses are not deductible under section 162(a).[6]

We hold for respondent.

Decision will be entered for respondent.

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[6] As to section 212, see n. 4, supra.

743-8 JU 11.7/2:1986-82

COMPLETED

T. C. Memo. 1986-82

UNITED STATES TAX COURT

BENEDICT and JOYCE ZACCARO, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 8494-85. Filed March 3, 1986.

Steven Walk, for the respondent.

MEMORANDUM OPINION

PETERSON, Special Trial Judge: This case was assigned to Marvin F. Peterson pursuant to section 7456(d) and Rules 180, 181 and 182.[1]

Respondent determined a deficiency in petitioners' 1982 Federal income tax in the amount of $4,000. The only issue is whether petitioners are entitled to a residential energy credit in the amount of $4,000.

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[1] Statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated, and all Rule references are to the Tax Court Rules of Practice and Procedure.

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Petitioners resided at 35982 Stevens Boulevard, Eastlake, Ohio 44094, at the time they filed their petition in this case. They filed a joint Federal income tax return for the calendar year 1982.

During 1982 petitioners installed a Geothermal Heat Pump with four wells drilled to a depth of 100 feet (system). The heat pump and wells were designed to heat and cool petitioners' personal residence using underground water as the source of energy. The underground water available for use in the system has a temperature of 11.7 degrees Celsius. The total cost of the system amounted to $10,383.

Petitioners claimed a $4,000 income tax credit on the ground that the cost of the system qualified as a renewable energy source expenditure under section 44C(a)[2] contending that the system transmits energy dervied from a geothermal deposit. Respondent disallowed the credit contending that the expenditure made by petitioners for the system did not qualify as a geothermal energy property under section 44C(c)(5) since the system does not transmit energy derived from a geothermal deposit as defined in section 1.44C-2(h), Income Tax Regs.

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[2] Section 44C was redesignated as section 23 by section 471(c) of the Deficit Reduction Act of 1984, 98 Stat. 494, 826 for years beginning after December 31, 1983.

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Petitioners recognize that the regulations require that the temperature of a geothermal reservoir must have a temperature exceeding 50 degrees Celsius at the wellhead to qualify as a geothermal deposit, but contend that the regulations are invalid since they are contrary to congressional intent.

Pursuant to section 44C(c)(6)(A)(i), the Secretary of the Treasury was given specific statutory authority to issue regulations which establish criteria to be used in prescribing performance and quality standards for renewable energy source property. Peach v. Commissioner, 84 T.C. 1312, 1315 (1985); Reddy v. Commissioner, T.C. Memo. 1984-395. Where regulations are issued pursuant to specific statutory authority, they are legislative in nature. It is well settled that legislative regulations are entitled to great weight. Olson v. Commissioner, 81 T.C. 318, 323 (1983); Wing v. Commissioner, 81 T.C. 17, 28 (1983). Further, such legislative regulations must be sustained unless unreasonable and plainly inconsistent with the statute they are intended to implement. Peach, at 1317; Olson, at 323.

In Peach we specifically addressed the issue of the validity of the regulations. We held that respondent's regulation requiring that the heat requirement of a geothermal deposit be in excess of 50 degrees Celsius was a reasonable interpretation of the statute. Peach, at 1317. Also, see Reddy, where we held that the temperature limitation was included in the regulation in order to insure that only property transmitting or using

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geothermal as opposed to surface source of energy qualifies as geothermal property and that such regulation was clearly consistent with section 44C(c)(5)(A).

We conclude that respondent properly disallowed the residential energy credit of $4,000 claimed by petitioners.

Decision will be entered for the respondent.

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742-B

JU 11.7/2:1986-83

COMPLETED

mf 126

T. C. Memo. 1986-83

UNITED STATES TAX COURT

GEORGE C. LEINING AND ROSE A. LEINING, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

GEORGE C. LEINING, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 676-84, 12465-84. Filed March 3, 1986.

George C. Leining, pro se.

Charles A. Ray, Jr., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WRIGHT, Judge: In these consolidated cases,[1] respondent determined deficiencies in and additions to petitioners' Federal income tax as follows:

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1 The years at issue in docket No. 676-84 are 1979 and 1980, and the year at issue in docket No. 12465-84 is 1981.

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George C. Leining and Rose A. Leining

Year	Deficiency	Addition to Tax Sec. 6653(a)[2]
1979	$ 815.00	—
1980	8,002.47	$400.14

George C. Leining

Year	Deficiency	Additions to Tax Sec. 6651(a)(1)	Sec. 6653(a)(1)	Sec. 6653(a)(2)	Sec. 6654(a)
1981	$16,112.13	$3,111.47	$805.61	50% of the interest due on $12,445.89	$883.46

Respondent has also requested that this Court impose damages under section 6673 against petitioner George C. Leining for 1981. The issues are (1) whether petitioners are entitled to various deductions for the years in issue; (2) whether petitioners are liable for an addition to tax under section 6653(a) for 1980; (3) whether wages constitute income; and (4) whether petitioner George C. Leining is liable for additions to tax under sections 6651(a)(1), 6653(a)(1), 6653(a)(2), and 6654(a) and for damages under section 6673 for 1981.

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2 All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

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FINDINGS OF FACT

Some of the facts have been stipulated and are so found. Petitioners George C. Leining (hereinafter sometimes called petitioner)[3] and Rose A. Leining resided in Meriden, Connecticut, when they filed their petitions in these cases.

We will consider separately each of the three years involved herein.

1979

Petitioners timely filed their Federal income tax return for 1979 and reported their income and deductions using the cash method.

During 1979, petitioners resided in Meriden, Connecticut, and Mr. Leining worked in North Haven, Connecticut, and in West Hartford, Connecticut. On their income tax return for 1979, petitioners claimed a deduction of $3,492 for employee business travel expenses arising out of petitioner's use of his car. The parties have agreed that petitioners are entitled to a deduction of $331.

1980

Petitioners timely filed their Federal income tax return for 1980 and reported their income and deductions using the cash method.

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[3] Rose A. Leining is a petitioner in this case solely by virtue of having filed joint Federal income tax returns with George C. Leining for 1979 and 1980.

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On their income tax return for 1980, petitioners claimed a deduction of $17,591.35 for employee business travel expenses incurred by petitioner with respect to a temporary job assignment in Kansas. Of that amount, $1,619.35 is claimed with respect to petitioner's use of his car and $15,972 is claimed with respect to meals and lodging. The parties have agreed that petitioners are entitled to deductions of $1,500 and $12,705 for these expenses, respectively. The parties further agree, however, that the $12,705 shall be reduced by $3,390 to reflect the amount petitioner received from his employer in 1980, and for which petitioner was not required to account. Petitioners did not take such reimbursement into account in computing their claimed deduction for travel expenses, nor did they include such amount in their gross income. Petitioners did not maintain records with respect to the amount, time, place, and business purpose of the travel expenses for which they claimed a deduction.

On December 21, 1980, petitioners reported to the police that various items were missing from their home, and were believed to have been stolen. The police report set forth the following items and valuations:

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Article	Value
Sterling silver service for 8	$5,000
3 auto tape decks	120
1 diamond ring	300
1 wedding band	100
Miscellaneous tools	[no stated value]
Brass and copper pipe fittings	[no stated value]
Various amounts of alcoholic beverages	unknown value
Various silver dollars and Kennedy half-dollars	[no stated value]
Alcoholic beverages[4]	800

The silver service was noticed missing on November 3, 1980. The other items were noticed missing during the week immediately prior to the police report. On their 1980 return, petitioners claimed a theft loss of $10,932.88 calculated as follows:

Sterling silver service	$10,231.85
5 cases assorted alcoholic beverages	600.00
Miscellaneous tools	201.03
Subtotal	$11,032.88
Less exclusion	100.00
Deduction claimed	$10,932.88

The sterling silver was purchased by petitioner and his former wife in 1952, just prior to their marriage. The alcoholic beverages were purchased by petitioner during the two years prior to the theft, one bottle at a time, in anticipation of his daughter's wedding. The tools were purchased by petitioner during the five to eight years prior to the theft. Petitioners based their deduction on what they considered to be the fair market value of each item at the time the theft was discovered.

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4 These alcoholic beverages were reported and valued separately from the above beverages. They apparently were the property of a social organization and were being stored temporarily at the Leining residence.

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For the silver, petitioners used the retail price in 1980 of a new sterling silver service comparable to the one stolen. With respect to the alcoholic beverages, petitioners calculated that there were 12 bottles in each of the 5 cases (60 bottles) and estimated the value of each bottle as $10.

1981

During 1981 petitioner was employed as a contract engineer and earned wages totaling $38,786.27. During that year petitioner also received other income in the amount of $1,808.40 from one of his employers and unemployment compensation of $2,400.00 from the State of Connecticut Department of Labor. Petitioner paid Florida property taxes of $31.06 in 1981.

For 1981 petitioner mailed to respondent a Form 1040. That form showed petitioner's name, address, filing status, and total number of exemptions claimed. Petitioner inserted only the words "object -- self-incrimination" on the lines provided on that form for information concerning income, deductions, credits, payments, and tax due.

Petitioner completed two years of college, has 32 years of experience in his field, and has worked as a contract engineer for more than 15 years. He filed proper Federal income tax returns, as required, for each year prior to 1981.

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OPINION

The issues presented herein are primarily concerned with petitioners' substantiation of various deductions claimed on their tax returns. Deductions are a matter of legislative grace; the taxpayer must satisfy the specific statutory requirements of the deductions claimed to reduce his tax liability. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). Respondent's determinations are presumptively correct and the taxpayer bears the burden of proving otherwise. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

1979

Petitioners' sole contention with respect to 1979 is that they are entitled to a deduction of $182 for business related travel expenses, in addition to the $331 allowed by respondent. The claimed amount is based upon petitioner's assertion that he paid a $.35 toll each time he traveled between his home in Meriden, Connecticut, and his places of employment in North Haven, Connecticut, and West Hartford, Connecticut, and that this amount was not included in the amount allowed by respondent. Amounts incurred in traveling to and from one's residence and regular place of employment are commuting expenses which are personal in nature and therefore not deductible as business expenses. Sec. 1.262-1(b)(5), Income Tax Regs.; Heuer v. Commissioner, 32 T.C. 947, 951 (1959), affd. per curiam 283 F.2d

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865 (5th Cir. 1960), and cases cited therein. Thus, we sustain respondent's disallowance of the deduction of the additional amount.

1980

Petitioners claimed a deduction of $10,932.88 on their 1980 return, based on the asserted theft of various articles from their home.

Under section 165, an individual may deduct losses caused by the theft of property to the extent that the loss exceeds $100 and is not reimbursed by insurance or otherwise.

Respondent first contends that petitioners have not proven that a theft in fact occurred. On this point, the evidence includes a police report setting forth the various items claimed to be missing. In addition, petitioner testified concerning details of the discovery of the theft, the items missing, and further explained that he did not claim a deduction for several of the items included in the police report because he was not the owner of those items. We have weighed the evidence on this issue and we find it credible. Accordingly, we find as a fact that petitioners did incur a loss in 1980 due to the theft of certain items from their home.

In order to establish entitlement to the claimed deduction, however, petitioners must prove not only the fact of loss, but the value of that loss. Elliott v. Commissioner, 40 T.C. 304, 311 (1963). The amount of the allowable loss is the lesser of

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(1) the property's fair market value immediately before the theft, or (2) the adjusted basis of the property. Secs. 1.165-7(b)(1) and 1.165-8(c), Income Tax Regs.; Ternovsky v. Commissioner, 66 T.C. 695, 697-698 (1976). Generally, the basis of such property is its cost. Sec. 1012.

First, petitioners claimed a deduction of $10,231.85 for the loss of eight place settings of sterling silver. This amount reflects the replacement cost of a new silver service and is, therefore, not the appropriate standard.[5] With respect to the valuation of this loss, petitioner testified that he did not know the cost of the silver service when it was purchased and he presented no evidence to establish the fair market value of the silver immediately before the theft. Noting generally the substantial inflation which has occurred in the 30 years since the silver was purchased and the dramatic increase in the cost of precious metals since that time, we conclude that the original cost of the silver service (petitioners' basis) would be lower than its fair market value in the year of the theft. Thus, the amount of the allowable deduction is petitioners' basis in the silver in question. In the absence of specific evidence, we will apply our best judgment to approximate this amount. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). Bearing heavily against the taxpayer "whose inexactitude is of his own making"

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5 See Jenny v. Commissioner, T.C. Memo. 1977-142.

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(Cohan v. Commissioner, supra at 544) we find that petitioners are entitled to a deduction of $400 for the loss by theft of the silver service.

Petitioners also claimed a deduction of $600 for five cases of alcoholic beverages. The deduction was based upon an estimated value of $10 per bottle. The record is not clear as to whether this is petitioners' basis in the liquor or its fair market value. In any event, petitioners produced no receipts and presented no evidence as to the amount, cost, type, or quality of the liquor, except for petitioner's self-serving statement that there were 60 bottles comprised of "various amounts of famous brands." Applying our best judgment, we find that petitioners are entitled to a deduction of $300 for the alcoholic beverages. See Cohan v. Commissioner, supra.

The final component of petitioners' theft loss deduction is the amount of $201.03 for miscellaneous tools. The tools were not described or listed in any way in the police report, but petitioner testified at trial that they included a "Skil" saw, a set of chisels, hammers, saws, and other items that he was unable to remember. He testified that he valued the tools for purposes of computing the theft loss deduction by "[doing] a fast price list" but presented no evidence showing an itemized breakdown of the claimed amount. No evidence was presented to show either the fair market value of the tools immediately prior to their loss or petitioners' basis. Again, under the Cohan doctrine, applying

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our best judgment to the record before us, we conclude that petitioners are entitled to a theft loss deduction of $100 for the tools.

The next issue is whether petitioners are liable for an addition to tax under section 6653(a). As applicable herein, that section provides for the imposition of an addition to tax if any part of any underpayment is due to negligence or intentional disregard of rules or regulations. Petitioners bear the burden of proving respondent's determination erroneous. Rule 142(a); Bixby v. Commissioner, 58 T.C. 757 (1972). Beyond petitioner's bare assertion that he was not negligent, petitioners introduced no evidence on this issue. Moreover, the record shows that petitioners did not keep any records to substantiate their deduction of $17,591.35 for travel expenses. We find that such failure to maintain records coupled with the failure to account for a reimbursement of $3,390 resulted in an underpayment of tax due to negligence or intentional disregard of rules and regulations. Accordingly, we sustain respondent's determination on this issue.

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1981

Respondent determined that petitioner had taxable income of $41,994.60 in 1981.[6] In his petition, petitioner sets forth numerous statements to the effect that he is a "natural individual" and not required to file a tax return or pay tax, and that wages are not income.[7] These arguments have often been considered and rejected by this and other courts and, accordingly, we deem them meritless. Rowlee v. Commissioner, 80 T.C. 1111 (1983), and cases cited therein; Harbersham-Bey v. Commissioner, 78 T.C. 304 (1982). Section 61 defines gross income as "all income from whatever source derived" and specifically includes compensation for services. Sec. 61(a); sec. 1.61-2(a), Income Tax Regs. Unemployment compensation generally is includible in income. Sec. 85. Accordingly, we sustain respondent's determination with respect to petitioner's receipt of taxable income in 1981.

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6 Respondent calculated petitioner's taxable income as follows:

Wages and fees	$40,594.60
Unemployment compensation income	2,400.00
	$42,994.60
Less exclusion	1,000.00
	$41,994.60

The $.07 difference between this figure and the amount of wages and income stipulated to by petitioner is unexplained.

7 Petitioner did not, however, advance these arguments at trial.

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At trial, petitioner claimed entitlement to deductions in various amounts for business related travel expenses, including meals and lodging.

Section 162 allows a deduction for traveling expenses incurred while away from home in pursuit of a trade or business. Congress, however, requires taxpayers claiming such deductions to comply with the stringent substantiation requirements of section 274(d).[8]

Section 274(d) provides, in part, that no deduction shall be allowed under section 162 or section 212 "for any traveling expense (including meals and lodging while away from home)," unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (1) the amount of such expense, (2) the time and place of the travel, and (3) the business purpose of the expense.

Substantiation by "adequate records" requires maintenance of an account book, diary, or similar record, and documentary evidence such as receipts or paid bills, but duplication is not necessary so long as the account book and receipt "complement each other in an orderly manner." Sec. 1.274-5(c)(2)(i), Income Tax Regs. However, documentary evidence is required for expenditures for lodging while traveling away from home and for any other expenditure of $25 or more (except for transportation, if not readily available). Sec. 1.274-5(c)(2)(iii), Income Tax

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8 See Ferretti v. Commissioner, T.C. Memo. 1982-375.

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Regs. The alternative method of substantiation, that of "sufficient evidence corroborating his own statement," allows the taxpayer to establish each element of an expenditure "(i) By his own statement, whether written or oral, containing specific information in detail as to such element; and (ii) By other corroborative evidence sufficient to establish such element." Section 1.274-5(c)(3), Income Tax Regs.

Petitioner offered no documentary evidence from which we could find that the claimed deductions were substantiated by adequate records. Nor has he provided the Court with specific information in detail to establish the requisite elements of the claimed expenditures. Absent strict compliance with the substantiation requirements under section 274(d), we are precluded from allowing any deduction based on approximation or the unsupported testimony of the taxpayer. Deely v. Commissioner, 73 T.C. 1081, 1101 (1980); sec. 1.274-5(a), Income Tax Regs. Accordingly, no deduction is allowed.

At trial petitioner contended that he was entitled to deductions of the following amounts claimed to have been paid during 1981: $1,000 for state sales tax, $260 for charitable contributions, $973.52 for city taxes of Meriden, Connecticut, $31.06 for Florida property tax, and $8,899.35 for interest paid on his home mortgage. Except for the payment of Florida property tax, petitioner testified from memory with respect to each of the above amounts and produced no receipts, canceled checks, or other

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evidence of either the fact or the amount of any of the above alleged payments. We are not convinced that petitioner incurred the claimed expenses, nor do we accept his testimony as to the amounts involved as reliable. Thus, petitioner has failed to meet his burden of proof. Accordingly, except for the payment of $31.06, no deductions are allowed. A deduction of $31.06 is allowed for petitioner's payment of Florida property taxes. Sec. 164.

The next issue is whether petitioner is liable for additions to tax under sections 6651(a)(1), 6653(a)(1), 6653(a)(2), and 6654(a). Section 6651(a)(1) imposes an addition to tax for failure to file a timely tax return, unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

This Court has held that a document need not be perfectly accurate or complete in order to constitute a return, as long as it purports to be a return, is sworn to as such, and evinces an honest and genuine endeavor to satisfy the requirements for a return. Jarvis v. Commissioner, 78 T.C. 646 (1982), and cases cited therein; Reiff v. Commissioner, 77 T.C. 1169, 1177 (1981). Further, it must contain sufficient information from which respondent can compute and assess the tax liability of a particular taxpayer. A Form 1040 which fails to contain this data does not constitute a "return." Thompson v. Commissioner, 78 T.C. 558, 561-562 (1982); Reiff v. Commissioner, supra.

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The Form 1040 filed by petitioner for 1981 discloses only petitioner's name, address, filing status, and number of exemptions claimed. Petitioner provided no information with respect to his income or deductions but, instead, apparently asserted a constitutional objection based on the Fifth Amendment by inserting the words "object -- self-incrimination" on each of the lines of the Form 1040. For the foregoing reasons, we find that the Form 1040 filed by petitioner does not contain sufficient information from which petitioner's income tax liability for 1975 could be computed, nor does it represent an honest and reasonable attempt to satisfy the requirements of the tax law. Therefore, we conclude that it does not constitute a return.

The requirement that taxpayers file tax returns in accordance with the provisions of the Internal Revenue Code and respondent's regulations does not violate the taxpayer's privilege against self-incrimination under the Fifth Amendment. Reiff v. Commissioner, supra; White v. Commissioner, 72 T.C. 1126, 1130 (1979), and cases cited therein. Thus, petitioner's general Fifth Amendment claim does not excuse petitioner from his obligation of providing the information required in an income tax return.

Petitioner, who bears the burden of proof on this issue (Rule 142(a)), introduced no evidence to show reasonable cause for his failure to file a proper return for 1981. Accordingly,

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respondent's determination with respect to the addition to tax under section 6651(a)(1) is sustained. Hatfield v. Commissioner, 68 T.C. 895, 898 (1977); Neubecker v. Commissioner, 65 T.C. 577 (1975).

Section 6653(a)(1) provides that, if any part of any underpayment is due to negligence or intentional disregard of rules and regulations, there shall be added to the tax an amount equal to five percent of the underpayment. Section 6653(a)(2) provides that there shall be added to the tax an amount equal to 50 percent of the interest payable under section 6601 with respect to the portion of the underpayment which is attributable to negligence or intentional disregard of rules and regulations and for the period beginning on the last date prescribed by law for payment. Petitioner bears the burden of proving that his underpayment was not due to negligence or intentional disregard of rules and regulations. Rule 142(a); Bixby v. Commissioner, 58 T.C. 757 (1972). Petitioner introduced no evidence on this issue and, thus, failed to satisfy his burden of proof. Furthermore, in years prior to 1981, petitioner demonstrated knowledge of his duty to file a return and how to properly report his income. Beard v. Commissioner, 82 T.C. 766, 780 (1984). Therefore, we sustain respondent's determination with respect to the addition to tax under section 6653(a)(1). We also sustain respondent's determination of the addition to tax under section 6653(a)(2) to be based on an underpayment of $12,445.89.

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Finally, section 6654 imposes an addition to tax for underpayment of estimated tax. Petitioner, who bears the burden of proving that respondent erred in determining that additions to tax should be imposed under this section (Rule 142(a)), introduced no evidence indicating that respondent so erred and, therefore, we sustain respondent's determination. Habersham-Bey v. Commissioner, 78 T.C. 304, 319-320 (1982).

The final issue is whether petitioner is liable for damages under section 6673. As applicable herein, section 6673 provides that damages up to $5,000 shall be awarded to the United States whenever it appears that proceedings before the Tax Court have been instituted or maintained primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless. After careful consideration of the entire record in this case, in our discretion we have determined that petitioner is not liable for damages.

To reflect concessions and the foregoing,

Decisions will be entered under Rule 155.

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T. C. Memo. 1986-84

UNITED STATES TAX COURT

DIVERSE INDUSTRIES, INC., Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3037-81. Filed March 3, 1986.

Lon M. Mickelson and Gerald I. Neiter, for the petitioners.

Marc J. Winter, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Judge: Respondent determined a deficiency of $52,761 in Federal income tax for petitioner's taxable year ended January 31, 1977. The sole issue for consideration is the amount that petitioner is entitled to deduct for that year as reasonable compensation to its president.

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FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner is a California corporation that had its principal place of business in Van Nuys, California, at the time it filed the petition in this case. For its taxable year ended January 31, 1977, petitioner timely filed a United States corporate income tax return with the Internal Revenue Service Center in Fresno, California.

Some time prior to 1973, Richard James (James) and Horace Kline (Kline) operated a modeling agency. While operating their agency, James and Kline became interested in marketing sexually oriented material by mail and began a mail-order business. Their mail-order company successfully advertised in men's magazines and grew in size, and ultimately the partners decided to abandon the modeling agency and concentrate their efforts on mail-order sales.

On January 23, 1973, the business, now known as Diverse Industries, Inc., was incorporated. James became president and Kline vice-president and secretary. On March 15, 1973, pursuant to a written agreement, Kline resigned as an officer of petitioner, and petitioner redeemed his 50-percent interest in the business. The agreement provided that petitioner, which had theretofore not issued any stock, would issue stock to James, who

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owned the other 50 percent of the interests of the corporation. Petitioner then issued 100 shares no-par value common stock to James.

Petitioner During James' Presidency

James acted as petitioner's president and sole shareholder until February 28, 1976, when he sold the business. He prided himself on running petitioner differently than most adult mail order companies, which he regarded as essentially one-man operations. To improve petitioner's efficiency, he developed a management team, consisting of Robert Easley, Gary Wolfe and Burt Goldman, to oversee and work with him on various aspects of the business.

Each of these men was a long-time employee and initially was hired for an entry-level position in petitioner's organization. None held a college degree. Easley did not have a high school diploma. Wolfe had completed two years of college and some classes in the field of graphic arts. Prior to his employment with petitioner, Wolfe had worked as a fry cook in a hamburger restaurant. Goldman's educational background consisted of one year of college classes in the field of business administration. Easley, Wolfe and Goldman nevertheless impressed James with their abilities, and assumed more and more responsibilities within the organization. Eventually, Easley became marketing director, Wolfe art director and Goldman financial officer.

James directed a business that sold sexually oriented movies, magazines, devices and other items. Marketing these provocative materials involved carefully identifying potential customers. Petitioner used special mailing lists for this purpose. Petitioner had two kinds of mailing lists: an in-house list, composed of the names of people who had responded to petitioner's ads in such publications as Playboy and Penthouse; and rental lists, composed of the names of people who had purchased from other companies items similar to those sold by petitioner.

Before purchasing a rental list, petitioner would test it by sending brochures or catalogs to a small random sample of names on the list. If the results of a test mailing were positive, petitioner would purchase more names from the list.

In addition to lists, petitioner tested the effectiveness and best use of individual brochures. Continual attempts were made to improve the quality of mailings. During James' presidency, petitioner issued its first full-color brochure.

Unlike most mail order companies, the conduct of petitioner's business was affected by stringent legal prohibitions on the distribution of its merchandise. In Miller v. California, 413 U.S. 15 (1973), the Supreme Court held that obscenity is determined by applying contemporary community

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standards, not national standards. In the same year as the Miller decision, James and petitioner were tried and acquitted in Austin, Texas, on obscenity charges.

James took a number of measures to avoid further obscenity prosecutions. He retained a lawyer with expertise in First Amendment cases and subscribed to publications dealing with censorship. Petitioner was required to purchase a post office list of names of persons who objected to receiving sexually oriented mail. James was careful not to send sexually oriented material to these persons. Additionally, James sent no mailings to certain geographical parts of the country. He made certain that order forms were correct and complete. In a further effort to avoid prosecutions under Miller, James hired Ron Raffaelli, a photographer whose work he admired, to produce products with "artistic merit."

Despite the precautions taken by James, on June 17, 1975, he and petitioner were indicted in the United States District Court for the Western District of Louisiana, charged with using the mails to send obscene literature illustrating films, books, magazines and devices, and other offenses.[1] On October 6, 1975,

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[1] Petitioner and James ran afoul of local authorities as well. In Dec. 1975, petitioner was served with a search warrant issued by a judge of the Municipal Court of Los Angeles Judicial District, County of Los Angeles, and the premises of petitioner were searched. Goldman was handcuffed during the raid, and petitioner's employees were searched.

On Aug. 6, 1976, after James had left the company, a misdemeanor complaint was filed against petitioner and James,

(footnote continued)

petitioner through James entered a plea of guilty to one count of the indictment, and James entered a plea of guilty to another count. On December 30, 1975, the court imposed the following sentence: (1) Petitioner was ordered to pay a $5,000 fine; (2) James was ordered to pay a $5,000 fine; (3) James was placed on a five-year probation with a special condition that he divest himself of all interest in petitioner within 60 days.

Compelled to sell petitioner within a 60-day period, James was intent upon receiving as much cash "up-front" as possible. No one outside of the company came forward with a reasonable offer. Running out of time and prospects, James considered offering petitioner to an employee of the company. He knew that no one in the company had the up-front money he desired, but liked the idea of transferring petitioner to someone he trusted and who had the knowledge necessary to run the company.

James first contacted Easley. Easley had been with petitioner longest in terms of service, and James had worked closely with him. Because of the lingering threat of prosecution, Easley was not interested in owning petitioner's stock under his own name. James then offered to sell petitioner's stock to Goldman. Like Easley, Goldman, who had a family, was not willing to take the risk of owning petitioner. James then contacted Wolfe. As petitioner's art director, Wolfe

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(footnote continued from previous page)
alleging violations occurring on or about Dec. 15, 1975. James pled guilty to two reduced counts of disturbing the peace and was fined $500 and placed on three years summary probation.

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was responsible for creating petitioner's brochures, catalogs, graphic design and, in collaboration with James, petitioner's written copy. Wolfe was interested in buying James' stock in petitioner.

Although Goldman and Easley were unwilling to be shareholders of record in petitioner, they were nevertheless interested in remaining with petitioner and having a financial stake in the corporation. On February 1, 1976, Wolfe, Goldman and Easley signed a document entitled "Co-Ownership Agreement" for the purpose of forming an investment partnership to acquire ownership of petitioner. The agreement provided that the partnership would acquire all of the outstanding shares of petitioner from James in the name of Wolfe, as nominee. It stated that Wolfe, Goldman and Easley, as co-owners of the partnership, would own the following respective percentage interests in the partnership and its asset, the shares of petitioner: 30 percent, 30 percent and 40 percent. The agreement recited that James, as a condition to the sale of his shares, required that Easley and Goldman remain employees of petitioner until March 31, 1979; it stated that Easley and Goldman agreed to accept employment with petitioner through that date. The agreement specified that Easley and Goldman were joint and several guarantors of a promissory note to be executed February 28, 1976, by Wolfe in favor of James to the extent of two percent of the unpaid principal balance.

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The agreement further provided that Wolfe would be managing co-owner with control over the shares and business operations of petitioner. Wolfe was not required to consult or confer with his other co-owners in making business decisions. The agreement authorized Wolfe to negotiate with James and acquire all outstanding shares of petitioner in Wolfe's own name for the partnership as beneficial owner.

On the evening of February 28, 1976, Wolfe and James executed documents entitled "Purchase and Sale of Stock," "Promissory Note" and "Escrow Agreement." Under the terms of the stock purchase agreement, James sold Wolfe 84 shares of petitioner at a price of $750,000, plus interest at 7 percent per annum, payable in 120 equal monthly installments commencing on April 1, 1976. The agreement provided that the purchase price would be evidenced by a negotiable promissory note from Wolfe, and that the stock would be held in escrow until the full purchase price was paid. The stock purchase agreement specifically limited Wolfe's salary as president to $50,000 per year, and Wolfe's, Goldman's and Easley's aggregate salaries to $125,000 per year "plus any increases due to the increases in the California cost of living index, and additional salaries for payment to Seller [James] in connection with the obligation owed hereunder." The escrow agreement specified that, pending payment

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of the full purchase price, all dividends declared on the shares held in escrow were to be applied to the payment of the next installment of principal and interest.

Consistent with the terms of the stock purchase agreement, petitioner then redeemed James' remaining 16 shares. James lent petitioner the money with which to purchase these 16 shares.

With James as its president and sole shareholder, petitioner's gross sales for its taxable years ended January 31 were as follows:

Year	Gross Sales
1974	$ 709,776
1975	1,580,007
1976	3,027,438

For these same taxable years, petitioner reported taxable income for Federal income tax purposes as follows:

Year	Taxable Income
1974	$ 67,466
1975	6,723
1976	171,992

Petitioner paid no dividends for these taxable years.

James, as president, received the following compensation for the fiscal years indicated:

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Year	Compensation
1974	$ 32,116
1975	134,070
1976	272,744

James' compensation for fiscal 1975 and 1976 was set by a contingent compensation formula adopted by petitioner's board of directors on January 15, 1975. The formula fixed James' salary at a base of $20,000, plus 10 percent of all gross sales in excess of $500,000. Petitioner's income tax returns for the fiscal years ended January 31, 1975, and January 31, 1976, were audited by respondent on the issue of the reasonableness of the compensation paid to James.

Immediately prior to the sale of petitioner, Wolfe's annual salary was $15,000. Goldman's salary was about $17,000, and Easley's salary was $27,000 to $28,000.

Petitioner During Wolfe's Presidency

During the taxable year ended January 31, 1977, Goldman and Easley maintained the same job responsibilities and duties with petitioner as they had prior to the sale. Wolfe acted in a general supervisory capacity and continued to retain control over the production of artwork. Decisions affecting inventory purchases and personnel pay scales were made by Wolfe, Goldman and Easley. Goldman made management decisions affecting warehouse operations and, along with Wolfe, the hiring and firing of personnel.

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Wolfe became president of petitioner at a time of change for the corporation. A number of important business developments had occurred prior to the sale. In May 1975, petitioner moved its offices from West Hollywood to Van Nuys, California. The move caused significant employee turnover. Petitioner's increased sales volume and the larger size of the Van Nuys offices had required hiring of additional personnel. After James' conviction on Federal obscenity charges, James curtailed petitioner's mailing activity. He made minimal use of in-house lists and immediately stopped using rental lists. At a time when competition in the marketplace was intensifying, James ordered an end to the testing of names on the lists.

Wolfe developed and improved petitioner's business practices. He increased the number and variety of petitioner's mailing pieces and produced all-color catalogs, which may have been an innovation in the industry. He reinstituted the cycle of testing and implemented the use of a computer system devised by James to better target mailings for specific items in petitioner's product line. Wolfe designed a book of photographs by Raffaelli, which became a successful item for petitioner. He completed work on a series of films commissioned by James but never released. He oversaw a reduction in the size of petitioner's work force to what he believed was a more efficient level. In an effort to avoid the legal problems James

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encountered, Wolfe interviewed and retained a new First Amendment counsel. During the period in question, no obscenity charges were brought against petitioner or Wolfe.

Subsequent to the sale of petitioner, Wolfe appointed himself and two friends as petitioner's board of directors. One of Wolfe's friends had experience in the sale and distribution of stuffed animal toys, while the other had no prior business experience. On the morning of March 1, 1976, petitioner's board of directors adopted a contingent compensation plan for Wolfe identical to the one in effect for James during petitioner's 1975 and 1976 fiscal years (i.e., a base salary of $20,000 plus 10 percent of gross sales in excess of $500,000).

Wolfe under the contingent compensation agreement received a total salary for the taxable year ended January 31, 1977, of $269,635. No portion of this salary was payment for services past rendered. In comparison, Goldman and Easley, who were not compensated on a contingent basis, received the following salaries: Goldman, $30,000-$35,000; Easley, $45,000.

On January 21, 1977, petitioner established an employee stock ownership plan (ESOP) for its employees. Under the ESOP, petitioner contributed $26,825 to Wolfe's account for the fiscal year ended January 31, 1977. Wolfe's combined compensation for the taxable year ended January 31, 1977, thus totaled $296,450.

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During calendar year 1976, Wolfe made payments to James pursuant to the stock purchase agreement in the approximate amount of $108,000. During the fiscal year ended January 31, 1977, Wolfe's payments to James on the promissory note averaged between $6,000 and $7,000 per month.

For its taxable year ended January 31, 1977, petitioner reported gross sales of $3,256,196, and taxable income of $182,969. Approximately 5.9 percent of petitioner's gross sales were made to wholesale buyers, and 94.1 percent to retail buyers. During the 1977 fiscal year, petitioner paid dividends of $15,120, which Wolfe received and applied towards payment of his note to James.

On its Federal income tax return for the taxable year ended January 31, 1977, petitioner claimed a deduction of $269,635 for compensation to Wolfe. As reflected on its income tax return, petitioner's equity was $82,089, and its net profits were $109,102.

Respondent by statutory notice disallowed $122,564 of petitioner's claimed deduction for Wolfe's salary. The notice stated that petitioner had not established that any amount above $147,071 represented reasonable compensation for personal services rendered. Respondent did not disallow any portion of petitioner's $26,825 contribution to Wolfe's ESOP account.

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OPINION

Section 162(a)(1)[2] allows a deduction for ordinary and necessary business expenses including "a reasonable allowance for salaries or other compensation for personal services actually rendered." There is a two-prong test for deductibility under section 162(a)(1): (1) The amount of the compensation must be reasonable and (2) the payments must in fact be purely for services. Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1243 (9th Cir. 1983), revg. and remanding a Memorandum Opinion of this Court. The inquiry into reasonableness is a broad one and generally subsumes the inquiry into compensatory intent. Elliotts, Inc. v. Commissioner, supra at 1245. Whether compensation is reasonable is a question to be resolved on the basis of an examination of all the facts and circumstances of a case. Charles Schneider & Co. v. Commissioner, 500 F.2d 148, 151 (8th Cir. 1974), affg. a Memorandum Opinion of this Court, cert. denied 420 U.S. 908 (1975); Pacific Grains, Inc. v. Commissioner, 399 F.2d 603, 605 (9th Cir. 1968), affg. a Memorandum Opinion of this Court. The determination of the Commissioner is presumptively correct, and the burden of proving the reasonableness of compensation is upon the petitioners. Botany Worsted Mills v. United States, 278 U.S. 282 (1929).

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2 All section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable year at issue.

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Many factors are relevant in determining whether compensation is reasonable,[3] and no single factor is decisive; the totality of facts and circumstances must be weighed. Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949),

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[3] The parties focus particularly on a number of the factors enumerated in Foos v. Commissioner, T.C. Memo. 1981-61. In Foos v. Commissioner, supra, we referred to the following factors:

1. Employee's qualifications and training.
2. Nature, extent, and scope of his duties.
3. Responsibilities and hours involved.
4. Size and complexity of the business.
5. Results of the employee's efforts.
6. Prevailing rates for comparable employees in comparable business. * * *
7. Scarcity of other qualified employees.
8. Ratio of compensation to gross and net income (before salaries and Federal income tax) of the business.
9. Salary policy of the employer to its other employees.
10. Amount of compensation paid to the employee in prior years.
11. Employee's responsibility for employer's inception and/or success.
12. Time of year the compensation was determined.
13. Whether compensation was set by corporate directors.
14. Correlation between the stockholder-employees' compensation and his stockholding.
15. Corporate dividend history.
16. Contingent compensation formulas agreed on prior to the rendition of services and based upon a free bargain

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revg. a Memorandum Opinion of this Court. In Elliotts, Inc. v. Commissioner, supra, the Ninth Circuit, to which this case would be appealable, divided these factors into five broad categories.

Role in Company

The first category of factors identified by the Ninth Circuit concerns the employee's role in the company. We shall consider Wolfe's qualifications, the nature of his duties as president and his performance of these duties.

A. Wolfe's Qualifications

An employee's superior qualifications may justify a high level of compensation. See, e.g., Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142, 1158 (1980); Capitol Market, Ltd. v. United States, 207 F. Supp. 376, 378-379 (D. Hawaii 1962). Respondent contends that neither Wolfe's academic record nor his prior experience justified his salary, while petitioner maintains

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between the employer and employee. * * *

17. Under-compensation in prior years.

18. Compensation paid in accordance with a plan which has been consistently followed.

19. Prevailing economic conditions.

20. Whether payments were meant as an inducement to remain with the employer.

21. Examination of the financial condition of the company after payment of compensation.

We will refer to many of these factors within the framework of our opinion.

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that Wolfe possessed a combination of skills from education and on-the-job training that eminently suited him for the position of president of petitioner. We agree with petitioner that Wolfe was well-qualified to become president of the company.

Wolfe's academic training, although not extensive, focused on the field of art, and artwork was vital to petitioner's success. There is no specialized educational preparation for becoming the chief executive officer of a company that sells erotic items. Familiarity with the personnel of the company, and knowledge of the workings of the business may be of primary importance in directing such an enterprise. Wolfe's innovations in marketing techniques during his presidency are evidence of both generalized and specialized skills and ability. Wolfe began at the bottom of petitioner's corporate ladder but worked his way up to key employee status prior to the sale. He was with petitioner during its growth and legal difficulties. Among petitioner's key employees, with whom he had worked for a number of years, Wolfe was the only one willing to face the risks associated with becoming petitioner's president. Thus, by training, experience and inclination, Wolfe had the ability that was necessary to direct this unconventional enterprise.

B. Nature of Wolfe's Duties

The extent of an employee's responsibilities and involvement in various aspects of the business is a factor in evaluating the worth of an employee. See, e.g., Elliotts, Inc. v. Commissioner,

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supra at 1245-1246; Roux Laboratories, Inc. v. United States, an unreported case (M.D. Fla. 1976, 38 AFTR 2d 76-6051, 76-2 USTC par. 9751). In moving from petitioner's art director to petitioner's chief executive officer, Wolfe's duties increased along with his salary. Like James, Wolfe was responsible for petitioner's success or failure. The record reflects that Wolfe was not a figurehead president. While remaining active in the art department (respondent concedes that under Wolfe petitioner "created brochures and catalogues in greater quantity and with more quality than prior to the sale"), Wolfe assumed new responsibilities in areas such as product selection and marketing, and exerted general day-to-day supervisory control over petitioner.

C. Wolfe's Performance as President

An employee's compensation may reflect his contributions to the business. See, e.g., Dave Fischbein Manufacturing Co. v. Commissioner, 59 T.C. 338, 352-353 (1972); Albert Van Luit Co. v. Commissioner, T.C. Memo. 1975-56. Respondent argues that James was responsible for the success petitioner enjoyed during the fiscal year ended January 31, 1977, and that Wolfe did little more than continue James' successful policies. Petitioner maintains that Wolfe's efforts were of great value to the corporation, and we agree.

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Respondent's opening brief states, "James neglected his duties as CEO [chief executive officer] for the last half of the fiscal year [ended January 31, 1976] because of his legal problems in Louisiana." Wolfe reestablished an involved and more progressive management style at petitioner. He implemented programs begun by James but never completed and, without James' influence, made important changes, such as selecting new counsel and expanding and upgrading the variety of petitioner's mailings.

Respondent maintains that during Wolfe's presidency petitioner's emphasis shifted from less to more sexually explicit products, and that petitioner's risk of prosecution correspondingly increased. The fact remains, however, that no prosecutions were initiated against petitioner or its president on account of activities conducted during Wolfe's presidency. In this respect, Wolfe succeeded where James had failed.[4]

Wolfe acted to insure petitioner's continuing viability and profitability. We cannot fault him for not making drastic changes in areas where no such changes were needed. Although petitioner experienced only a small rate of growth in fiscal 1977

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[4] We are not herein concerned with Wolfe's or petitioner's morality, but with the reasonableness of compensation paid. It is our duty in this case to construe the revenue statutes, and not to express any judgment concerning the morality or social utility of petitioner's activities. See Associated Industries of Cleveland v. Commissioner, 7 T.C. 1449, 1466 (1946).

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relative to earlier years, both its gross sales and its taxable income reached then record levels. We believe that Wolfe deserves considerable credit for this success.

External Comparison

The second category of factors involves a comparison of the employee's salary with those paid by similar companies for similar services. Industry standards are important in determining whether compensation is reasonable. See, e.g., Pepsi-Cola Bottling Co. of Salina, Inc. v. Commissioner, 61 T.C. 564 (1974), affd. 528 F.2d 176 (10th Cir. 1975); Trucks, Inc. v. United States, 588 F. Supp. 638 (D. Neb. 1984), affd. 763 F.2d 339 (8th Cir. 1985). As section 1.162-7(b)(3), Income Tax Regs., provides, "It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

Both parties presented expert testimony as to what level of salary was reasonable for an executive in a position comparable to Wolfe's. Petitioner called as its expert Robert Howard, the executive vice president of Houlihan, Lokey, Howard & Zuskin, Inc., a valuation consulting firm. In his written report to the Court, Howard concluded that Wolfe's salary for the fiscal year 1977 was reasonable based on (1) the risks to reputation and person involved, (2) the complexity of Wolfe's duties and the

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number of hours he worked each week,[5] and (3) the fact that Wolfe was compensated under the same contingent compensation formula used for James. Howard considered petitioner to be "highly unique," and one of only a small number of companies for which a comparable company could not be found. He stated that his testimony and report were based not on empirical data but on his experience and knowledge of petitioner. He related that in early 1977 his firm was engaged to value petitioner's stock and that it has been subsequently engaged annually to value that stock.

Respondent called as its expert witness Emmet James Brennan, III. As president of Brennan, Thomsen Associates, Inc., Brennan conducts pay studies and surveys. In the summary findings of a written report submitted to the Court, Brennan compared the pay levels of chief executive officers of firms with sales revenues of $3.256 million (petitioner's gross sales) in all industries, the retail industry, the wholesale industry, the nondurable goods manufacturing industry, the publishing industry and the motion picture industry.[6] The following table summarizes his findings:

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5 According to Howard's report, Wolfe consistently worked in excess of 40 hours per week. Howard testified that Wolfe worked from 60 to 70 hours per week. Howard was unable to identify precisely his source for this information.

6 The report indicates that Brennan had difficulty classifying petitioner for pay comparison purposes. Brennan chose these six categories as possible industry matches for petitioner.

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Industry Classification	Competitive Total Pay	Maximum Reasonable Total Pay
All Industries	$73,935	$ 92,419
Retail	52,791	65,989
Wholesale	70,210	87,762
Nondurable	61,066	76,332
Publishing	88,771	110,964
Motion Pictures[7]	*	*

Brennan's summary findings[8] were supplemented by survey data on each of these industries.

Brennan prepared his summary findings under the assumption that petitioner paid bonuses to its employees. He subsequently concluded, however, that petitioner was not a bonus-paying company. Brennan stated that non-bonus-paying companies tend to pay less than bonus-paying companies and, therefore, his summary figures were excessively high. He further testified that his report was based on the hypothesis that Wolfe was an irreplaceable chief executive and that since preparing the report he had concluded that Wolfe was not. Brennan concluded that Wolfe was overcompensated.

We regard the expert evidence of both parties as flawed. Based on his testimony and credentials, Howard, petitioner's expert, seemed less qualified in the specific area of executive

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7 Because the data sources available for this category applied only to firms with sales in excess of $273,000,000, Brennan did not make a finding as to competitive and maximum reasonable pay.

8 Although the competitive base pay figures determined by Brennan reflect lesser amounts than allowed by respondent in the notice of deficiency, respondent nevertheless states that he is willing to allow petitioner the amount set forth in the notice. Respondent does not explain how he arrived at the amount proposed in the notice ($147,071) as reasonable compensation for Wolfe, or attempt to reconcile this amount with Brennan's figures.

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compensation than his counterpart, Brennan. In reaching his conclusions regarding the reasonableness of Wolfe's compensation, Howard relied less on factual data, which we can independently evaluate, than on his experience and judgment, which we cannot. We find his method to be suspect[9] and consequently accord his opinion relatively little weight. Brennan, on the other hand, presented us with considerable factual data to support his conclusions. His report was well-documented, and his method seemed thorough. Brennan, however, offered no data on businesses that sell sexually oriented publications, movies and devices. We are not satisfied that a reasonable level of compensation for an executive like Wolfe can be accurately determined by reference to the industries Brennan surveyed because of the absence of significant information on other businesses similar to petitioner's.[10] Comparing the compensation paid officers of

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[9] Howard's sources of information often seemed to be somewhat questionable. For example, in his report he stated that "military mercenaries demand substantial sums to fight due to the risk of physical harm and the social stigma attached to such endeavors." He likened sellers of sexually explicit material to military mercenaries with respect to risk taking. On cross-examination, respondent's counsel questioned him about the above quotation:

> Q. Where did you get your information on military mercenaries?
>
> A. Based on newspaper accounts, which I can agree may or may not be factual. Again, a general perception, a general knowledge.

[10] Moreover, we would not be bound by Brennan's findings even if we were to conclude that they established a norm for the compensation payable for Wolfe's services. Sec. 162(a)(1) was (footnote continued)

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companies that differ markedly provides guidance of dubious quality. See Giles Industries, Inc. v. United States, 227 Ct.Cl. 496, 504, 650 F.2d 274, 278 (1981); Niagara Falls Coach Lines, Inc. v. Commissioner, T.C. Memo. 1977-269. Accordingly, we are unable to attach much weight to Brennan's opinion.

Character and Condition of Company

The third general category of factors identified by the Ninth Circuit concerns the character and condition of the company. The Court stated that the focus under this category may be on the company's size, as indicated by its sales, net income or capital value, and the complexities of the business and general economic conditions. Elliotts, Inc. v. Commissioner, supra at 1246.

Petitioner's gross sales during the taxable year ended January 31, 1977, were $3,256,196. As measured by this figure, petitioner was a relatively small-sized business. As we have indicated, however, petitioner occupied a rather unusual niche in the business world. Because of its product line, petitioner faced challenges significantly different from those encountered by most businesses, and it did so in a highly competitive

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(footnote continued from previous page)
not designed to regulate businesses by denying them a deduction for the payment of compensation in excess of the norm. Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142, 1162 (1980). The deduction is merely limited to a reasonable salary under the circumstances. Lefkowitz v. Commissioner, T.C. Memo. 1983-356.

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marketplace. While neither party presented evidence with which we can definitively compare petitioner's operations with those of similar businesses, the evidence suggests that petitioner was one of the larger and more successful companies of its kind.

Conflict of Interest

The fourth category of factors described by the Ninth Circuit includes those that may indicate a conflict of interest.

> The primary issue within this category is whether some relationship exists between the taxpaying company and its employee which might permit the company to disguise nondeductible corporate distributions of income as salary expenditures deductible under section 162(a)(1). Such a potentially exploitable relationship may exist where * * * the employee is the taxpaying company's sole or controlling shareholder. * * * [Fn. ref. and citations omitted.]

Elliotts, Inc. v. Commissioner, supra at 1246.

Under the category of "conflict of interest" we will address two factors discussed by the Ninth Circuit in Elliotts, Inc. v. Commissioner, supra, the existence of free bargaining in determining compensation and the perspective of a hypothetical independent investor in evaluating the compensation payments.

A. Existence of a Free Bargain in Determining Compensation

For the taxable year at issue, Wolfe was paid under a contingent compensation formula. Section 1.162-7(b)(2), Income Tax Regs., provides as follows with respect to contingent compensation plans:

> The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not

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> follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

Petitioner argues that Wolfe's compensation was set by an arm's-length bargain. Respondent, on the other hand, maintains that the contingent compensation agreement was not entered into under an atmosphere of free bargaining. We agree with respondent.

The question of whether a compensation agreement results from a "free bargain" is one of fact. All circumstances bearing upon the ability of the employer to exercise a free and independent judgment are relevant to that question. Harolds Club v. Commissioner, 340 F.2d 861, 865 (9th Cir. 1965), affg. a Memorandum Opinion of this Court.

On the evening of February 28, 1976, Wolfe and James contracted that Wolfe's salary as petitioner's president would not exceed $50,000 "plus any increases due to the increases in the California cost of living index, and additional salaries for payment to Seller in connection with the obligation owed hereunder." (Emphasis added.) Petitioner's board of directors met the next morning. The board, composed of Wolfe and two personal friends without related business experience or

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demonstrated independence, set Wolfe's compensation according to the same formula used for James. The compensation formula, of course, allowed Wolfe to earn more than $50,000 per year and gave Wolfe the means to make the payments on his obligation to James. Other than his compensation from the corporation, Wolfe had no obvious means to make the $6,000 to $7,000 monthly payments due James.[11] Given petitioner's failure to establish the independence of the directors who determined Wolfe's salary and Wolfe's obvious need for funds and lack of an alternative source for his payments to James, we cannot say that Wolfe's contingent compensation was "not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual."

B. Hypothetical Independent Investor's Evaluation

The Ninth Circuit stated that in evaluating the reasonableness of compensation paid to a shareholder-employee, it is helpful to consider the matter from a hypothetical independent shareholder's perspective:[12]

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11 Neither party explains how Wolfe made $108,000 in payments during calendar year 1976 when his monthly payments, which began Apr. 1, 1976, were between $6,000 and $7,000.

12 Our discussion of the hypothetical independent investor factor proceeds without the benefit of argument by petitioner and respondent. To our surprise, neither parties' brief contained this factor or cited Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983), revg. and remanding a Memorandum Opinion of this Court, where the hypothetical investment factor is discussed at length.

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> If the bulk of the corporation's earnings are being paid out in the form of compensation, so that the corporate profits, after payment of the compensation, do not represent a reasonable return on the shareholder's equity in the corporation, then an independent shareholder would probably not approve of the compensation arrangement. If, however, that is not the case and the company's earnings on equity remain at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company disguised as salary. [Fn. ref. omitted.]

Elliotts, Inc. v. Commissioner, supra at 1247.

As reflected on its Federal income tax return for the taxable year ended January 31, 1977, petitioner's equity was $82,089 and its net profits (profits less taxes and compensation paid Wolfe) was $109,102.[13] This amounts to a rate of return on equity of almost 133 percent. This rate of return on equity obviously would please an independent investor, and suggests that petitioner and Wolfe may not have been exploiting their relationship. An independent investor, however, might very well chafe at the effect of the provision in the escrow agreement requiring all dividends to be applied to the payment of Wolfe's obligation to James. Petitioner during the taxable year ended January 31, 1977, paid dividends for the first time in its corporate history, but the full amount of the dividend was applied towards payment of Wolfe's note.

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[13] To arrive at petitioner's equity, we added together the listed amounts for paid-in or capital surplus, capital stock, and unappropriated retained earnings. To arrive at its net profits, we subtracted petitioner's total tax from its taxable income.

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Internal Consistency

The fifth and final set of factors identified by the Ninth Circuit is internal inconsistency in a company's treatment of payments to employees. Evidence of such inconsistency may indicate that payments go beyond reasonable compensation. Elliotts, Inc. v. Commissioner, supra at 1247. In determining whether the salary paid a particular employee is reasonable, the salaries paid other employees of the business are relevant. Home Interiors & Gifts, Inc. v. Commissioner, supra at 1159; Kipnis v. Commissioner, T.C. Memo. 1982-471; Ken Miller Supply, Inc. v. Commissioner, T.C. Memo. 1978-228. The existence of a longstanding, consistently applied compensation plan is evidence that questioned salary payments are reasonable. Elliotts, Inc. v. Commissioner, supra at 1247.

During the taxable year ended January 31, 1977, Wolfe received $269,635 in salary,[14] while Goldman received between $30,000 and $35,000, and Easley received $45,000. Respondent argues that the disparity among these three salaries is persuasive of the unreasonableness of Wolfe's salary. Respondent notes that his expert, Brennan, testified and presented survey data that the second-ranking executive in a corporation receives about 70 percent of the chief executive's compensation, and that the third-highest paid executive tends to receive compensation

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14 As we have indicated, Wolfe additionally received a $26,825 contribution to his ESOP plan. Respondent, on brief, does not argue that this amount represents unreasonable compensation.

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fairly close in amount to the second executive's pay. We decline to measure the comparative worth of Wolfe's services by reference to Brennan's formula. As we have indicated, we disagree with Brennan's opinion regarding Wolfe's qualifications and performance as president. Nevertheless, we are influenced by the difference among Wolfe's, Easley's and Goldman's compensation. Although Wolfe, as president, had significantly greater responsibilities than Easley and Goldman, all three men were key and long-time employees of the corporation. Each performed an important role in the Wolfe administration. Easley made management decisions affecting such areas as inventory purchases and personnel pay scales; Goldman was active in such areas as warehouse operations and the hiring and firing of personnel. We do not believe that petitioner's salary structure accurately reflects the relative managerial responsibility of these three men.

Wolfe was compensated under a contingent compensation formula used during the taxable year ended January 31, 1977, for the first time to compensate Wolfe and for the third time to compensate petitioner's president.[15] Accordingly, it is difficult to regard the contingent compensation formula as a

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15 Petitioner argues that respondent's allowance of deductions to petitioner for the taxable years ended Jan. 31, 1975, and Jan. 31, 1976, for James' salary under the contingent compensation plan establishes that Wolfe's salary for the taxable year ended Jan. 31, 1977, was reasonable. This, of course, is incorrect. See Owensby & Kritikos, Inc. v. Commissioner, T.C. Memo. 1985-267 at n. 10, and cases cited therein.

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compensation practice of longstanding duration. Compare Elliotts, Inc. v. Commissioner, supra at 1247-1248 (predetermined formula in use for over 20 years); Streckfus Steamers, Inc. v. Commissioner, 19 T.C. 1 (1952) (modified in 1942, contingent compensation plan challenged for the years 1942-1946 first adopted in 1931); Albert Van Luit Co. v. Commissioner, supra (contingent compensation formula challenged for 1969 and 1970 adopted in 1946).

Conclusion

We have considered the factors relevant in deciding reasonable compensation for Wolfe. Based on all of the evidence, we hold that reasonable compensation for Wolfe for the taxable year ended January 31, 1977, was $200,000 in salary plus $26,825 in contributions to his ESOP account.

Accordingly,

Decision will be entered under Rule 155.

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